



CHAPTER 12

Conclusions

The previous 10 chapters have outlined some of the FDIC's most notable failing bank resolutions. Although they represent a very small number of the 1,617 bank resolutions that took place during the 15-year period, they represent some of the FDIC's most innovative resolution strategies. These case studies were designed to give the reader a feel for the challenges faced by the agency from 1980 through 1994.

This Conclusions chapter is presented in four parts: Resolutions, Assets, Liabilities, and Equity. Each of these sections will highlight some of the lessons learned by the FDIC. See table II.12-1 for a summary of the resolutions.

Resolutions

The preceding 10 case studies of significant resolutions discussed several different resolution structures such as open bank assistance and the creation of bridge banks. The case studies also discussed the FDIC's use of cross guarantee authority and its bidding procedures.

Open Bank Assistance¹

Of the 10 case studies presented, 4 involved open bank assistance (OBA).² During the early 1980s, OBA was the only resolution method used for larger banks requiring FDIC financial assistance. OBA was effective in minimizing the costs of failing banks,

1. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 5, Open Bank Assistance, for a full discussion of OBA transactions.

2. Four of the chapters present case studies of open bank assistance (OBA): Chapter 2, First Pennsylvania Bank, N.A., Philadelphia, Pennsylvania; Chapter 4, Continental Illinois National Bank and Trust Company, Chicago, Illinois; Chapter 5, First City Bancorporation of Texas, Inc., Houston, Texas; and Chapter 6, First Republic Bank Corporation, Dallas, Texas.

Table II.12-1

Significant Bank Resolutions

(\$ in Millions)

Name and Location	Resolution Date	Total Assets	Resolution Cost	Resolution Type	Depositor Treatment	Creditor Treatment
First Pennsylvania Bank, N.A. (First Penn), Philadelphia, Pennsylvania	04/28/80	\$7,953	\$0	OBA	Full protection	Full protection
Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma	07/05/82	517	65	Insured deposit payoff	Uninsured depositors not given 100 percent protection	No special protection; approved claims received dividends
Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois	05/17/84	33,633	1,104	OBA, with asset management contract	Full protection through explicit FDIC guarantee	Full protection through explicit FDIC guarantee
First City Bancorporation of Texas, Inc. (First City), Houston, Texas	04/20/88 and 10/30/92	11,200 and 8,852	1,069 and 0	OBA and 20 bridge banks; P&As with loss sharing	Full protection and all depositors eventually paid in full	Full protection and all creditors eventually paid in full
First Republic Bank Corporation (First Republic), Dallas, Texas	07/29/88	33,448	3,856	One bridge bank; P&A with asset management contract	Full protection through explicit FDIC guarantee	Third party creditors protected; interbank funding not protected
MCorp (MCorp), Dallas, Texas	03/28/89	15,749	2,840	One bridge bank; P&A with asset management contract	Full protection at 19 of 20 banks	Unsubordinated general creditors protected; interbank funding not protected
Bank of New England Corporation (BNE Corp.), Boston, Massachusetts	01/06/91	21,754	887	Three bridge banks; P&A with asset management contract	Full protection through explicit FDIC guarantee	Full protection except to credit-ors affiliated with holding company
Southeast Banking Bancorporation (Southeast), Miami, Florida	09/19/91	10,478	0	P&A with loss sharing	Full protection; acquiring bank assumed all deposits	Full protection
Seven Failing Banks in New Hampshire (The New Hampshire Plan), Various Cities, New Hampshire	10/10/91	4,377	891	Two P&As with loss sharing; one asset management contract	Full protection; acquiring banks assumed all deposits	Full protection
CrossLand Savings, F.S.B. (CrossLand), Brooklyn, New York	01/24/92	7,269	740	Conservatorship; stock sale	Full protection	Only subordinated debt and contingent liabilities not protected
Totals		\$155,230	\$11,452			

Source: FDIC, Division of Resolutions and Receiverships.

maintaining public confidence in the banking system, and continuing banking services in the affected communities. Initially, OBA worked well, but it became less effective over time. Open bank assistance was not used at all after 1992.

Changes in the Law and Their Effects on Open Bank Assistance. The power to complete OBA was provided to the FDIC under the Federal Deposit Insurance Act (FDI Act) of 1950. As the case studies have shown, OBA authority was important to the resolution of several of the larger troubled banks in the early to mid-1980s. The resolution of First Penn shows the difficulty that the FDIC would have had if OBA was not available as a resolution option. The restrictive branching laws made it improbable that the FDIC would have successfully located a purchase and assumption (P&A) candidate for First Penn. Because of the size of First Penn, it also would have been difficult for the FDIC to complete a payoff transaction.

The FDI Act required that a bank be considered “essential” to its community for it to receive OBA. The FDIC struggled with the concept of determining when a bank was “essential.” Nevertheless, OBA was used to facilitate the mergers of many insolvent mutual savings banks in 1981 and 1982. First Penn and the mutual savings banks pointed out the need for OBA at that time. The Garn–St Germain Depository Institutions Act (Garn–St Germain) of 1982 gave the FDIC greater latitude to provide OBA by eliminating the “essentiality” requirement in situations where OBA was determined to be less costly than paying off the bank’s insured depositors.

The lack of potential purchasers for First Penn brought to light the problem of state branching restrictions. The FDIC sought relief from Congress from those restrictions in 1982 and, with Garn–St Germain, Congress gave the FDIC limited authority to seek out-of-state bidders in certain emergency failing bank situations. That authority was of particular assistance in the resolutions of failing Texas institutions a few years later when the depressed economy limited the number of in-state institutions that were eligible to purchase the Texas banks that failed. The Competitive Equality Banking Act (CEBA) of 1987 further expanded the FDIC’s authority to seek out-of-state purchasers by allowing out-of-state holding companies to acquire large institutions under emergency circumstances.

In 1984, when the FDIC was faced with the potential failure of Continental, it used its 1982 authority under Garn–St Germain to solicit out-of-state bidders but was unable to quickly find an acquirer or merger partner for the bank. A payoff was not considered feasible because a large number of small banks and credit unions held uninsured deposits and could have failed if the FDIC paid off Continental’s insured deposits. Foreign depositors would have suffered losses, as well, negatively affecting the nation’s international banking business. Using the FDI Act, the FDIC determined that the continued operation of Continental was essential, and granted OBA.³

3. Because the FDIC believed that providing assistance might be more costly than a payoff, it could not provide open bank assistance unless the bank was deemed “essential.”

Although CEBA provided the FDIC with the ability to create bridge banks in 1987, that authority was not used when the FDIC provided OBA to the subsidiary banks of First City in 1988. In response to a proposal from a group of outside investors who had gathered \$500 million in new capital, the FDIC provided OBA to First City for two reasons. First, the transaction appeared to be beneficial to the FDIC, because the new investors were bringing new capital into First City. Second, the First City banks were large and complex, and the FDIC did not view those banks as an acceptable venue in which to try out the new bridge bank procedures. The FDIC provided OBA because the assistance provided was less than the estimated cost of resolving the banks through other means.

In 1988, the FDIC provided assistance to the two lead banks of First Republic using the essentiality criterion. The First Republic banks were experiencing a liquidity crisis, and the FDIC needed to act quickly. Convinced that the failure of First Republic's two lead banks would cause all the other First Republic banks to fail, the FDIC determined that the lead banks were essential and granted OBA.

Liquidity Issues Requiring a Quick Resolution. The large, troubled banks in need of FDIC assistance frequently had serious liquidity problems that required a quick solution making a P&A transaction difficult, if not impossible, to complete. Three of the OBA transactions examined initially had liquidity problems. First Penn was experiencing a deposit run that included withdrawals by some regional banks and even deposit brokers, and the bank had tied up its liquidity in long-term securities. Continental's liquidity crisis also threatened its ability to remain open. Because of the seriousness of Continental's deposit run, the FDIC had to act quickly to provide interim OBA to prevent Continental's failure. The FDIC wanted the bank's depositors to understand that in any OBA transaction, depositors would suffer no loss as a result of the assistance. The FDIC issued an explicit statement guaranteeing that no depositors or general creditors of Continental would suffer any losses as a result of the FDIC's actions. First Republic is another example of a financial entity that suffered liquidity problems before its resolution. First Republic's two lead banks were experiencing deposit runs. Even though the FDIC had recently gained bridge bank authority, the agency provided OBA to the First Republic banks on an interim basis to give the holding company time to search for new investors. The owners of the holding company pledged the rest of the company as security for the loans to the lead banks.

Equity and the Treatment of Shareholders. One concern regarding OBA was whether shareholders of an assisted institution would receive the same benefit from OBA that they would have received if the bank was actually closed. The 20 million warrants for stock provided to the FDIC and the commercial bank lenders in the First Penn case sufficiently diluted the existing shareholders' interests in the bank, decreasing any return to them. First Penn's shareholders did not receive benefit until after the FDIC's assistance loan had been repaid in full.

In the Continental transaction, the FDIC purchased convertible preferred stock that could be converted into 80 percent of the common stock of Continental's holding

company, effectively diluting the interests of the former stockholders to 20 percent. In addition, the FDIC received a purchase option for the former shareholders' remaining shares of stock in the holding company. The option was exercised when the FDIC suffered losses on the loans purchased from Continental, and the FDIC purchased the former shareholders' stock in the holding company for a nominal amount. That transaction effectively wiped out the equity interests of the former shareholders of Continental's holding company, just as if Continental had been closed.

The FDIC's 1988 assistance to the subsidiary banks of First City was secured by stock in the Collecting Bank. In that transaction, the original shareholders' investments were reduced to less than 2 percent of total equity in the holding company.

Although experience showed that shareholder investments were almost entirely eliminated in OBA transactions, concern over possible benefits under OBA led to legislation passed in 1993. Under the Resolution Trust Corporation Completion Act, failing bank shareholders were restricted from receiving any benefit from OBA.

Open Bank Assistance—Problems and Shortfalls. As OBA became more common, bank shareholders and bondholders began to manipulate the transactions. The First City transaction, for example, pointed out some of the problems of using OBA in dealing with sophisticated creditors. The First City bondholders believed that the FDIC would not let the First City banks fail (because Continental had not failed), and the bondholders learned that they could "use the system" to their advantage by refusing to negotiate and by holding out for better terms.

Another shortfall of OBA highlighted by the First City transaction was the limited control held by the FDIC over bank management once the agreement was completed. This had not been a problem at First Penn or at Continental. In the case of First City, however, the new management was not effective, and the banks eventually failed in spite of the assistance.

Investors who acquired failed institutions through P&A transactions had a competitive advantage over those who received OBA. P&A acquirers were relieved of contingent liabilities and from burdensome contracts such as high lease rates, standby letters of credit, and excessive fees for outside service providers. New acquirers did not have to negotiate with the shareholders or bondholders of the failing banks.

In providing OBA to large, troubled institutions, the FDIC received criticism for "nationalizing" the banks and for creating an unfair competitive advantage for large banks over smaller banks that did not receive OBA. Officers of small banks and elected officials complained that large banks received special treatment simply because of their size and, after the resolution of Continental, the term "too big to fail" was used for the first time. The general public came to think of OBA as an FDIC "bailout" of large banks.

OBA was the only feasible resolution for First Penn. The transaction is viewed as successful, partly because it gave First Penn time to work out its problems. The transaction also was beneficial to the FDIC, because First Penn eventually became profitable, repaid its assistance from the FDIC two years early, and the resolution resulted in no cost to the deposit insurance fund.

The FDIC also could view the Continental resolution (although controversial) as successful because it likely prevented the failure of a large number of small financial institutions that had deposits in Continental and possibly prevented a domino effect that could have rippled through the banking system. Foreign depositors were protected, which helped maintain international banking business for banks throughout the United States. Also, Continental's OBA was provided at a relatively low cost to the FDIC, 3.3 percent of the bank's total assets.

The First City OBA transaction in 1988 provided the FDIC a benefit by bringing \$500 million of new money into the First City enterprise. The amount of money raised by the new investors, however, proved to be inadequate, leading to a second resolution of First City in 1992.

The assistance provided to First Republic's two lead banks in 1988 was only an interim measure that gave the holding company time to look for new investors. The benefit to the FDIC was the pledge from the holding company of all its other assets. When the two lead banks failed, the asset pledge acted like a cross guarantee, allowing the FDIC to use value in the solvent banks to offset some of the losses in the insolvent banks. This was important because the FDIC did not have cross guarantee authority at the time. Cross guarantee authority was not granted until the passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989.

Initially, OBA worked very well for large, failing institutions, and it was used in many situations. As the banking crisis continued, however, OBA began to lose its effectiveness and there were fewer instances in which OBA was appropriate. The FDIC had more resolution alternatives after it received authority to create bridge banks in 1987 and the ability to assess cross guarantees in 1989. Those changes in the law, along with least cost requirements that became law in 1991 and the law restricting OBA from providing any benefit to a failing bank's shareholders, led to the decline in OBA transactions.

Bridge Banks

The bridge bank authority received by the FDIC under CEBA was an important resolution tool for a large, failing institution.⁴ In the 10 bank case studies presented, there were four instances in which bridge banks were established.⁵ Three of the other studied banks failed or were provided assistance prior to the enactment of the bridge bank legislation. Having the option to set up a bridge bank provided benefits to the FDIC in several ways.

4. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks, for a full discussion of bridge banks.

5. Four of the chapters present case studies of bridge banks: Chapter 5, First City Bancorporation of Texas, Inc., Houston, Texas; Chapter 6, First RepublicBank Corporation, Dallas, Texas; Chapter 7, MCorp, Dallas, Texas; and Chapter 8, Bank of New England Corporation, Boston, Massachusetts.

First, bridge banks eliminated the problems associated with OBA. After it received bridge bank authority, the FDIC did not have to negotiate with an institution's shareholders and bondholders to complete a transaction agreement. Second, when a bridge bank was established, a receivership was created for the former bank. Liabilities and claims that hampered the operation and profitability of the original bank, and most contingent liabilities, could be cut off and left in the receivership. Third, the FDIC controlled the bridge bank and could provide bidders with access to perform their due diligence, which improved the bidding process for the former bank. Fourth, the bridge bank remained open so that service was provided to the community and the value of the deposit franchise was protected.

The case studies show that the FDIC's process for establishing bridge banks changed over time. In the case of First Republic, which was the FDIC's first use of a bridge bank for a large banking entity, the FDIC already had a winning bidder selected to take over control of the former bank's assets. In that instance, because the FDIC had provided interim assistance to two of the First Republic banks earlier in the year, prospective bidders had access to perform due diligence on the former banks. Using the authority granted under Garn–St Germain to solicit out-of-state acquirers, the FDIC was able to have a buyer waiting when the banks failed. The FDIC formed one bridge bank for all of First Republic's 40 banks in Texas, and the buyer took over management of the bridge bank the same day. NCNB operated the bridge bank until it could purchase the FDIC's remaining interest in the bridge bank over a year later.

The MCorp transaction, which occurred shortly after the First Republic transaction, was similar to that of First Republic, in that the new entity, Banc One, operated the bridge bank until it could purchase the FDIC's interest in the bridge bank more than 18 months later. Unlike First Republic, however, the FDIC had not solicited potential purchasers before the banks' failure. In that case, the bridge bank provided the FDIC with time to solicit bidders and to allow the bidders to perform due diligence. Three months after creation of the bridge bank, the FDIC announced a winning bidder.

The 1991 failure of the BNE Corp. banks was handled a bit differently. In that case, three bridge banks were set up, one in each state where the former banks had operated. After the banks failed on January 6, 1991, prospective bidders started their due diligence and a winning bidder was selected in April of the same year. The acquirer operated the three bridge banks under an interim agreement, followed in June 1991 by a servicing agreement for the FDIC's assets and in July 1991 by the final P&A agreement. At that point, the bridge banks were dissolved.

Finally, in the case of the First City transaction in 1992, a bridge bank was set up for each of the holding company's 20 failed banks. By that time, legislation had been enacted requiring that the least cost resolution for each failed bank be used, and each of the 20 individual bridge banks was marketed separately. That structure likely resulted in the higher-than-anticipated premiums from the acquirers, which led to a no-cost transaction for the FDIC.

Use of a bridge bank allowed the FDIC to leave certain liabilities with the receiver, rather than transferring them to the bridge bank. As receiver, the FDIC could repudiate any of the former bank's contracts that might have harmed the value of the franchise. Contingent liabilities and interbank loans to affiliates could be retained in the receivership and eliminated from the bridge bank, which increased the sale value of the bridge bank.⁶ Two examples shown in the case studies bring out this point. Receivership certificates were provided for interbank loans at both the First Republic and the MCorp closings, although all other depositors and general creditors were protected.⁷ The forced recognition of loss caused the affiliated banks to fail and helped the FDIC recover some of its costs from the other banks in each holding company.

The lawsuits filed against the FDIC by First Republic's bondholders and by the MCorp holding company over the interbank loans were probably responsible for 1989 legislation that clarified the rights and responsibilities of the FDIC with regard to creditors. Specifically, the legislation provided that the FDIC, in its discretion and to minimize its costs, may make additional payments to any creditor of a failed bank as long as each creditor receives what it would have received from the liquidation of the failed bank's assets. That discretionary authority is significant to the FDIC, because it helps preserve the franchise value of a bridge bank.

Conservatorships and Bridge Banks—A Comparison. CrossLand was resolved by using a conservatorship, which functioned in a manner similar to that of a bridge bank. The failed bank was placed in receivership, providing the FDIC with the same advantages regarding contracts and liabilities as a bridge bank. The conservator could repudiate or disaffirm any of the failed bank's contracts that were considered burdensome, thus avoiding any future obligations imposed by the contract. The conservator also could void security interests in property, even if perfected, if the security interest had been taken with fraudulent intent.

The conservator, as well as a receiver, substitutes for the bank in all pending litigation, can request courts to stay litigation, has all cases resolved in federal court, and has extended periods of time to file contract claims and tort suits. The conservator can avoid fraudulent transfers of property made within five years before or after the conservator's

6. Banks are required to maintain certain levels of reserves, either in vault cash or, if they are members of the Federal Reserve System, in deposits at a Federal Reserve Bank. Banks that are not members of the Federal Reserve System may satisfy reserve requirements by keeping deposits in banks that are members of the Federal Reserve System and that pass the balances through to the Federal Reserve Bank. Because the reserve requirements fluctuate daily, one way banks can meet their requirements is by borrowing excess balances in Federal Reserve deposits, particularly from affiliated banks. In banking, excess balances borrowed are called "Fed Funds Purchased," excess balances loaned are called "Fed Funds Sold."

7. At MBank Abilene, N.A. (MBank Abilene), Abilene, Texas, only insured deposits were transferred to the new bridge bank. Uninsured depositors and general creditors of MBank Abilene were treated in a different manner from similarly situated creditors of the other MCorp banks, because MBank Abilene, as successor to the former Abilene National Bank, had approximately \$60 million in outstanding judgments filed against it.

appointment, and those avoidance rights are superior to any rights of a bankruptcy trustee competing for the same transferred property.

The conservator also had “special defenses” similar to those of a receiver. Any agreement that was not properly documented in the institution’s records, therefore, could not be enforced against the conservator either to make a claim or to defend against a claim by the conservator. Courts were prohibited from issuing injunctions or similar equitable relief to restrain the conservator from completing its resolution and liquidation activities.

After extensively marketing CrossLand, the FDIC received no acceptable bids and proceeded with the conservatorship resolution. Although the FDIC’s decision to place the failed savings bank into a conservatorship generated much public comment and criticism, the transaction proved to be cost effective. The FDIC’s experience demonstrates that, in some instances, a bridge bank or a conservatorship can be operated with a long-term goal of improving an institution’s franchise value.

Most bridge banks were temporary solutions, lasting only a few months; the conservatorship lasted longer than most of the bridge banks. The two exceptions were the First Republic bridge bank, which was operated for a little more than a year, and the MCorp bridge bank, which was operated for approximately two and a half years. Both of those bridge banks were resolved rather quickly but were not terminated, because the acquirers needed time to purchase the FDIC’s interest. The purpose behind the CrossLand conservatorship and its length of duration was to improve the institution and get it ready for sale, whereas the FDIC’s objective in a bridge bank is to gain control of an institution so that it can be sold quickly. From an operations standpoint, however, the conservatorship was little different from a bridge bank. The creation of a business plan, the hiring of an outside executive to run the conservatorship, and the working out of assets in an open bank environment also can be completed in a bridge bank.

Cross Guarantee Authority

The problems encountered by the FDIC in the closings of the First Republic and MCorp banks caused the agency to request cross guarantee authority from Congress. The cross guarantee authority granted by Congress under FIRREA in 1989, is significant to the FDIC because it helps the FDIC recover some of its costs for handling troubled banks. Cross guarantee authority was used in the 1991 resolutions of Bank of New England, Boston, Massachusetts, and Southeast Bank, N.A., Miami, Florida.

One of the most instructive examples of the FDIC’s use of its cross guarantee authority was in the 1992 First City transaction. Two of the First City banks were insolvent, which led to the FDIC assessing cross guarantees against the other 18 banks. Although losses were expected in 4 of the 20 banks, the cross guarantee allowed the FDIC to retrieve value from the 16 better-capitalized banks. That value led to no loss being incurred by the deposit insurance fund.

Bidding

In the early phases of the banking crisis, the FDIC did not offer potential purchasers many options regarding the failing institutions. The most commonly used resolution method was a P&A transaction in which the FDIC protected all depositors, both insured and uninsured. As the laws and the economy changed and the FDIC gained experience, the FDIC started offering more types of resolutions.⁸ The FDIC used those new resolution types to develop bidding alternatives designed to increase the pools of bidders and stimulate competition. When Garn–St Germain and CEBA removed many of the state laws restricting interstate banking and intrastate branching, it enabled the FDIC to attract out-of-state acquirers for large failing banks.

The FDIC frequently offered prospective purchasers of large institutions the option to bid on asset purchases with “put back” options, that is, the eventual acquirer was allowed to require the FDIC to repurchase certain assets. Depending on the size of the institution and the quality of the asset portfolio, some purchasers were allowed to put back assets that could be classified according to bank examination standards, and some purchasers were allowed to put back any assets they did not want.

Asset put backs had some advantages for the FDIC. First, acquiring institutions did not need to spend as much time on due diligence reviews before a bank’s failure, because there was no risk in acquiring the failed bank’s assets. Second, the FDIC did not have to acquire all of a failed bank’s assets at the time of its failure. Finally, FDIC management viewed the higher percentages of assets passed at resolution to the acquirers as a way to minimize disruption in the failing banks’ communities. As the FDIC’s inventory of failed institution assets continued to grow, however, the FDIC looked for better ways to pass more assets to acquiring institutions.

To further improve the bidding alternatives, the FDIC developed the concept of loss sharing. Loss sharing was primarily designed to sell as many failed bank assets as possible. The FDIC’s agreement to reimburse an acquiring institution for the bulk of its net losses on assets purchased reduces the potential risk of the acquirer to a more definable amount. Potential purchasers were more likely to submit bids when they were assured that they would not be responsible for the entire amount of loss in a failed bank’s asset pool, particularly if there had not been much time to perform due diligence on the assets to be acquired. Loss sharing essentially replaced giving an acquirer put back rights.

Capital Assistance to Acquirers. The FDIC on several occasions has encouraged interested purchasers to submit bids for failing institutions by offering to provide interim capital assistance. That capital assistance increased an acquirer’s capital and helped it take on the additional liabilities and assets of the failing institution. Capital assistance is discussed in more depth later in this chapter in the section titled “Equity Investments.”

8. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 2 Overview of the Resolution Process, and Chapter 3, Evolution of the FDIC’s Resolution Practices, for a full discussion of various resolution alternatives.

Multiple Bank Bidding. When the First Republic and MCorp banks failed, the FDIC formed one bridge bank for each group. In each case, all deposits were transferred into the bridge bank. At the time, Texas had restrictions on intrastate branching and selling one bank with multiple locations was unique to the FDIC's resolution activities. Acquirers were selected either right before the banks failed, or very shortly thereafter. In 1990, the RTC began experimenting with multi-branch institutions by marketing and selling the individual branches separately. In marketing and selling the First City bridge banks in 1992, the FDIC increased bidding by offering each of the 20 bridge banks individually. The FDIC received 111 bids from 32 potential purchasers for the 20 bridge banks, resulting in a much higher than anticipated premium of \$434 million. The FDIC believes that marketing each bridge bank separately increased competition and allowed bidders the flexibility to bid only on those banks they really wanted, thereby increasing the premiums received.

Assets

Asset Management Contractors

In the early years of the banking crisis, the FDIC worked all liquidation assets in-house. With the Continental resolution, the FDIC began using the former bank's staff to manage and collect some of the FDIC's assets. Contracting with acquirers of large failed banks to service the FDIC's assets became common as the banking crisis deepened and the FDIC's volume of liquidation assets grew larger. The handling of assets from small banks continued to be worked by the FDIC in-house. Gradually, the FDIC began to contract with third-party asset managers rather than acquirers. The FDIC also searched for other methods of disposing of failed bank assets, and the concept of loss sharing was introduced, enabling the FDIC to transfer some of its credit risk to acquirers.

Assisted Bank Retains Assets. The earliest case study, First Penn, is an example of OBA in which the FDIC provided financial assistance but took back no assets. Because the assisted bank retained all the assets, it bore all the risk of loss.⁹ The success of the plan depended primarily on the management of the subject bank and economic conditions. First Penn eventually returned to health, and the resolution resulted in no cost to the FDIC. A comparison can be made to First City's OBA. In 1988, First City retained all of its assets and risk of loss, and the banks eventually failed. First City was never able to repay its OBA loans, and the FDIC had to write off its capital investment.

At the time of Continental's resolution in 1984, the FDIC had approximately \$4.3 billion in assets in liquidation from previous bank failures. Continental had approxi-

9. Actually, if the bank incurs too much loss and fails, the FDIC is faced with another resolution and must deal with the loss at that point.

mately \$5.2 billion of problem assets that, if acquired and managed by the FDIC, would have required the FDIC to more than double its staff. In addition, Continental's assets were much larger, individually, than most of the assets the FDIC was working in-house, and the FDIC did not have the expertise to handle many of the specialized maritime, commercial, and international loans.

The Continental agreement illustrates some of the advantages of contracting for the FDIC to use employees of the failed bank to collect the FDIC's loans. The contractor was already familiar with the assets and was a specialized collection group (not the lending group that had originated the loans). The contractor also had the expertise needed for Continental's specialized loans, and the FDIC did not have to hire and train new employees for that work. Part of the agreement required the FDIC to pay all of the contractor's expenses. That cost-plus option was used because the newly organized Continental retained only the good loans of the bank and did not need the special collection group, other than to collect on the problem assets retained by the FDIC.

The agreement also included an incentive plan for the contractor. The more money the contractor brought in, the more incentive fees it earned, effectively increasing the contractor's motivation and aligning its interests with those of the FDIC. The incentive fees on Continental were relatively nominal at \$8 million, or about 0.35 percent of total asset recoveries net of asset-related expenses. To ensure that the contractor worked the assets according to FDIC policies and procedures, a small group of FDIC employees were on-site to monitor the performance of the contractor. That use of a private-sector collection group worked well for the FDIC and was used at some of the largest bank failures encountered by the FDIC. In addition to Continental, in the 10 case studies presented, asset management contractors were used at First Republic, MCorp, BNE Corp., and the New Hampshire Plan banks.

Acquiring Bank as Servicer. The First Republic contract for the management of \$11 billion in assets was a learning experience for the FDIC. As part of the FDIC's agreement with the assuming bank, the bridge bank retained ownership of the assets and managed them. The resolution of the First Republic banks was the FDIC's most expensive resolution. While most of the cost can be attributed to the huge losses in the loan portfolio, the contract itself also proved to be expensive. The FDIC learned from that experience and three provisions contained in the First Republic servicing contract were improved in future agreements. First, the acquirer of the First Republic banks funded the pool assets with reimbursement from the FDIC. Although that arrangement reduced the FDIC's initial cash outlay, helping to preserve the liquidity of the deposit insurance fund, it raised the overall cost of the transaction to the FDIC because the acquirer had a higher funding cost than the FDIC. Second, the servicing agreement cap on management incentive fees was reached after only two years, leaving the servicer with little incentive to aggressively manage the assets for the remainder of the five-year term. Third, because the FDIC reimbursed the servicer for all asset-related expenditures, there was no incentive for the servicer to control costs. The FDIC renegotiated the contract after two years to include provisions that better aligned the servicer's interests with those of the FDIC.

The contract for the management of \$4.2 billion in assets from the MCorp banks was somewhat improved from the First Republic contract. Again, the acquirer, acting in its bridge bank capacity, owned and managed the assets. In the history of the FDIC, the resolution of the MCorp banks is the second largest, in terms of cost, to First Republic. Although the primary costs were associated with the losses in the asset portfolio, the FDIC's servicing contract also was expensive. The MCorp contract contained one significant change from the contract for First Republic: the management incentive fee was tied to net collections, rather than gross collections. That modification was designed to induce the servicer to control expenses.

Both the First Republic and the MCorp P&A agreements contained provisions that allowed the acquiring banks to put assets from the banks into the special asset pools. Those put back provisions were necessary because of the size of the failed banks' assets and the credit risks associated with them. No bidder was willing to purchase those assets without considerable and expensive due diligence and steep discounts in price. The FDIC found that, to complete a transaction quickly after a bank failure, it was necessary to allow the acquiring institutions the option to put risky assets back to the FDIC. The ability to return assets to the special asset pool kept the acquirers' risks at a minimum. For First Republic, the original asset pool was \$9.1 billion with a market value of \$6.1 billion; and total puts over the two-year put period were \$1.9 billion in book value with a market value of \$1.6 billion. For MCorp, the original asset pool was \$2.5 billion in book value, and during the life of the contract, assets with a total of \$4.2 billion in book value and market value of \$3.2 billion were placed in the pool.

In the contract for the three BNE Corp. banks, the FDIC retained ownership of the assets because it had a lower cost of funds, which reduced holding costs. As an inducement to control expenses, the FDIC paid the servicer incentive fees based on net collections, rather than gross collections. The contractor's treatment of borrowers from the BNE Corp. banks became a controversial issue. Although the contractor was servicing the portfolio, the FDIC, as well as the contractor, was criticized for insensitive collection practices. That criticism led to an increased emphasis on customers' rights, for the assets the FDIC worked in-house and for those assets worked by the contractors. A second part of solving the problem for borrowers at BNE was the sale of a package of those loans from the FDIC back to the acquiring bank with a guarantee against loss from the FDIC. The sale of 2,000 loans with a total book value of over \$700 million reinforced the FDIC's attitude that loans needed to be kept with the acquirer. The return of those borrowers into an open bank environment helped provide them with a way out of the "credit crunch" in the area.

Third-Party Asset Management Contractors. The contract for managing the assets from the New Hampshire Plan banks in 1991 is an example of a resolution involving a third-party asset management contractor. With that resolution, for the first time, the FDIC solicited asset management bids from outside contractors, as well as from the assuming banks. Because the FDIC knew it would also be adding assets to the contract from other failed banks, the solicitation required the contractors to be capable of servic-

ing \$2 billion in assets. The FDIC received seven bids from asset managers and the contract was awarded to a third-party asset servicer.

Contract asset managers work assets in much the same way that the FDIC works its own assets in-house. Contractors may occasionally, however, have some specialized skills for particular assets, can pay higher salaries and bonuses not tied to governmental pay scales, and thus can generally attract personnel with greater experience or specific knowledge.

Future contracts were improved on as the FDIC gained more experience with contracting. For example, the contract for the MCorp bank assets was an improvement over the contract for the First Republic bank assets. After Continental, the FDIC went on to use a total of 14 asset management contracts to liquidate more than \$33 billion of assets, or nearly half of the failed bank assets the FDIC retained for liquidation.

Loss Sharing

While asset management contracting worked well for the FDIC, by 1991 the FDIC had learned that retaining ownership of problem assets meant paying all the collection expenses and bearing all the credit risk in the loans.¹⁰ The FDIC believed that assets left in the banking sector retained more value than those placed in liquidation, primarily because of maintaining consistency in the customer-institution relationship. To overcome the reluctance of acquiring institutions to purchase certain assets from failing banks and thus to sell more assets, however, the FDIC had to address the problems of limited due diligence, poorly underwritten loans, and declining real estate markets. In the Southeast resolutions, the FDIC developed the concept of loss sharing, a variation of a P&A transaction, to limit the downside risk to acquirers.¹¹

By designing the loss sharing agreements so the FDIC absorbed a significant portion of any credit losses, the FDIC was able to attract potential acquirers willing to purchase hard-to-sell assets during the resolution process. The acquirers' risks were minimized and could be better quantified. By having the acquirer absorb a limited amount of credit loss, the FDIC attempted to ensure rational and responsible credit management behavior by the acquirer. Because of the additional administrative duties and costs for both the acquirer and the FDIC in managing the agreement, the FDIC believed that loss sharing was generally efficient when the pool of shared loss assets was more than \$100 million. The loss sharing transactions that have taken place have led to lower average costs than other resolution methods.

10. The FDIC also developed Regional Asset Liquidation Agreements, in which collection expenses were limited, for smaller banks. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 14, Asset Management Contracting.

11. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 7, Loss Sharing, for a full discussion of this subject.

The FDIC used loss sharing in the September 1991 resolution of Southeast, followed by the New Hampshire Plan in October 1991, the 1993 resolution of First City, and the sale of CrossLand Federal in 1993.¹²

The FDIC views the loss sharing agreement with the acquirer of the Southeast banks as a success for two reasons. First, the bank's acquirer bought all \$10.1 billion of Southeast's assets except owned real estate, bank premises, other assets, and subsidiaries, including more than \$2 billion in nonperforming assets or performing problem loans. Second, the FDIC's total loss sharing payments to the acquiring institution were less than 70 percent of the original estimated costs. The two loss sharing agreements in the New Hampshire Plan resolution involved only small residential mortgages and other consumer loans. The FDIC's total cost of loss sharing for this resolution was approximately 36 percent of the original estimated cost.

In 1992, the FDIC sold three of the 20 First City bridge banks to two different acquirers using loss sharing provisions. For those agreements, the FDIC added a provision for 95 percent reimbursement of net loss if the net loss reached a "transition amount." In that instance, the FDIC's loss sharing costs were underestimated. The FDIC's total loss sharing payments for both agreements were roughly 119 percent of the amount estimated by the FDIC in 1992 (\$82 million instead of \$69 million, a \$13 million difference). Total loss share payments were still only about 3 percent of the total book value of the assets.

The final loss sharing agreement in the bank studies is the one completed for the CrossLand resolution. The CrossLand loss sharing agreement differed from previous agreements in that the bank's purchasers had to absorb the first \$179 million in losses on the \$2.8 billion portfolio of loans and owned real estate. The loss sharing agreement was designed to protect the purchasers from large, unknown losses. The agreement required the FDIC to absorb 80 percent of the losses after the \$179 million threshold was reached. Total loss sharing payments were approximately \$34 million or 1.2 percent of assets covered.

Because it has been used generally in larger transactions, loss sharing has been very successful at keeping assets in the private banking sector and lowering costs to the FDIC. On average, losses on assets covered by loss sharing have been approximately 6 percent of the beginning balances of the assets. From September 1991 through December 1994, the FDIC used loss sharing a total of 16 times to resolve 24 failed institutions with total assets of \$41.4 billion.

Summary. The dollar volume of assets retained by the FDIC from any failed bank typically depends on the quality of the specific assets. Good assets are nearly always passed to the acquiring bank, and the FDIC typically retains marginal and poor quality assets.

12. Four of the chapters present bank studies involving loss sharing: Chapter 9, Southeast Banking Corporation, Miami, Florida; Chapter 10, The New Hampshire Plan; Chapter 5, First City Bancorporation of Texas, Inc., Houston, Texas; and Chapter 11, CrossLand Savings, F.S.B., Brooklyn, New York.

Before the Continental resolution, the FDIC always liquidated failed bank assets using in-house staff. The Continental asset management contract supplemented the in-house efforts. As asset management contracting became more common, FDIC's in-house staff still played an important role in the disposition of asset from large failed banks. The FDIC's in-house staff developed and negotiated the asset management contracts and provided oversight for the contracts. The FDIC's in-house staff absorbed assets that represented conflicts of interest for contractors or that the contractors were not servicing properly. As contracts reached their termination dates, the FDIC in-house staff also took in any remaining loans from the contracts. Studies conducted by the FDIC reveal that the costs of resolutions, whether worked in-house or by contractors, have been similar.

The use of asset management contractors and the development of loss sharing were two of the most important changes in the way the FDIC disposed of assets from large failed banks. For the 10 bank case studies presented in Part II, the FDIC's resolution cost and the handling of the failing institution's assets is shown in table II.12-2.

Liabilities¹³

The FDIC was formed in 1933 to make sure that, if a bank failed, insured depositors would be able to recover their funds quickly.¹⁴ As receiver of a failed financial institution, however, the FDIC is responsible for liquidating the institution's assets and distributing the proceeds to the failed institution's creditors. The laws concerning the order of payment preference have changed over the years.¹⁵

The case studies demonstrate how the FDIC handled liabilities in various situations. The liabilities of a failed bank or thrift include obligations to depositors, general creditors, shareholders, and holding companies. Others with claims against the failed bank may include shareholders and creditors of the holding company.

13. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 8, The FDIC's Role as Receiver; Chapter 9, The Closing Process and Payment of Insured Depositors; and Chapter 10, Treatment of Uninsured Depositors and Other Creditors, for a full discussion of deposit insurance.

14. The FDIC was formed in 1933, and federal deposit insurance coverage became effective January 1, 1934.

15. Before passage of the National Depositor Preference Amendment on August 10, 1993, each state had established its own priority for the payment of creditors of failed state chartered banks. In all national and some state chartered banks, all unsecured creditors shared equally in the recoveries of the receiverships. Some states, however, had established that all depositors must be paid before any other creditors could be paid. Those were known as depositor preference states. The priority for paying allowed claims against any failed, federally insured, depository institution is now determined by federal law. The law gives payment priority to depositors, including the FDIC as subrogee, over general unsecured creditors, for all receiverships established after its enactment. Under the National Depositor Preference Amendment and related statutory provisions, claims are paid in the following order of priority: (1) administrative expenses of the receiver; (2) deposit liability claims (the claim of the FDIC as subrogee takes the position of the insured deposits); (3) other general or senior liabilities of the institution; (4) subordinated obligations; and (5) shareholder claims.

Depositors

After passage of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), because of that law's least cost requirement, and after enactment of the National Depositor Preference Amendment in 1993, depositor treatment changed.

Out of the 10 notable bank resolutions studied, Penn Square was the only failed bank that was paid off. The payoff was completed through the use of a Deposit Insurance National Bank (DINB), which provided the FDIC with a method of paying the insured depositors that was easier than providing each depositor with an insurance check. In the aftermath of Penn Square, the prevailing feeling was that perhaps the

Table II.12-2

Failing Bank Resolution Cost and Asset Disposition Method

(\$ in Thousands)

Name of Bank	Assets at Resolution	Resolution Cost	Cost as a Percentage of Assets	Asset Option
First Penn	\$7,953,000	\$0	0.00	Retained by bank
Penn Square	516,799	64,970	12.57	Retained by FDIC
Continental	33,633,000	1,103,083	3.28	First asset mgmt. contract
First City—1988	11,200,002	1,069,107	9.55	Retained by bank
First City—1992	8,851,815	0	0.00	Loss share on three banks
First Republic	33,488,025	3,856,826	11.52	Asset mgmt. contract
MCorp	15,748,537	2,839,514	18.03	Asset mgmt. contract
BNE Corp. banks	21,754,001	886,988	4.08	Asset mgmt. contract
Southeast banks	10,478,311	0	0.00	First loss share
New Hampshire Plan	4,377,351	890,799	20.35	Asset mgmt. contract and loss share
CrossLand	7,269,198	739,941	10.18	Loss share

Source: FDIC Division of Finance.

FDIC would be less inclined to protect uninsured depositors and unsecured creditors at failed institutions than it had been in the past.

Penn Square also led to a debate over brokered funds. Because brokers combined depositors' funds but kept each depositor within insurance limits, bankers had access to an almost unlimited source of funds for liquidity purposes. In 1984, the FDIC and the Federal Home Loan Bank Board¹⁶ issued a joint rule that limited deposit insurance on brokered deposits according to the entire amount of the deposit, but an appeals court overturned the rule in 1985. Passage of FIRREA in 1989 restricted troubled institutions from accepting brokered deposits.

In the cases of First Penn, Continental, and First City in 1988, all depositors were protected against loss due to the nature of the OBA transaction. Furthermore, in the case of Continental, the FDIC issued an explicit statement fully protecting Continental's depositors and general creditors. The statement was designed to slow the deposit run being experienced by Continental, averting liquidity pressures. The FDIC's statement also provided assurance to the group of commercial banks that had participated in the FDIC's \$2 billion loan to Continental. The banks were concerned that all depositors would not understand that all depositors and general creditors of the institution, as a consequence of the OBA transaction, were fully protected against loss.

The assistance provided to First Republic was an interim measure that stabilized the banks until the permanent resolution could be finalized. When the FDIC promised to protect the depositors and creditors of the First Republic banks, the agency accomplished two goals beyond stemming deposit runs. First, the promise helped stabilize the 41 subsidiary banks through the period of interim assistance and soothe depositors' fears. When the FDIC reaffirmed the statement of depositor and general creditor protection on the date the banks failed and were placed in a bridge bank, the FDIC also provided the assuming bank with confidence that the franchise value of the bridge bank would remain intact.

The resolution of MCorp was different from the standard P&A agreements in which all of the depositors and general unsecured creditors were protected. Although the FDIC formed one bridge bank for all 20 failed banks, and again wished to protect the future franchise value of the bridge bank, all depositors and general creditors were fully protected in only 19 of the banks. MBank Abilene, N.A. (MBank Abilene), Abilene, Texas, had approximately \$60 million in outstanding judgments. Limiting the losses at the receivership level for MBank Abilene was the only cost-effective resolution possible for that institution and only the insured deposits were transferred to the bridge bank. Because MBank Abilene was a national bank, all creditors shared ratably in liquidation proceeds, and therefore uninsured depositors and general creditors of MBank Abilene were not protected.

16. The Federal Home Loan Bank Board was the governing board for the Federal Savings and Loan Insurance Corporation (FSLIC), the insurer of deposits in savings and loan associations. Both the Federal Home Loan Bank Board and the FSLIC were abolished in 1989.

The FDIC's third and final explicit statement of depositor and general creditor protection was in connection with the failure of the BNE Corp. banks. The statement was made on the date the banks failed and were placed in bridge banks. In the neighboring state of Rhode Island, 45 credit unions had failed only five days earlier. The credit unions had been insured by a state insurance fund that had gone broke, and the credit unions' depositors were concerned about getting their deposits back. The FDIC considered the various resolution alternatives available for the BNE Corp. banks and determined that any resolution that did not fully protect the banks' depositors would likely have a seriously adverse effect on the community. The FDIC's guarantee of depositor and general creditor protection helped calm fears surrounding the poor economic conditions in the entire region, and also helped preserve the value of the bridge bank franchise.

In the 1991 P&A transactions involving Southeast and the New Hampshire Plan banks, the FDIC determined that providing full protection for depositors resulted in the lowest possible cost to the deposit insurance fund, because the bidding for the banks was centered on the value of the deposit base. The general trade creditors were not protected in either case.

The FDIC's 1992 decision to place CrossLand in conservatorship came less than a month after passage of FDICIA. Although the resolution of CrossLand was not a P&A transaction, the FDIC determined that it was necessary to protect all depositors because failure to do so would seriously diminish the franchise value of the conservatorship. The General Accounting Office (GAO) later criticized the action, noting that, after the January 1992 conservatorship decision, resolutions in New York and Texas showed that not protecting uninsured depositors did not result in depositor runs.

First City is the only example in the case studies of banks resolved using the FDICIA least cost requirements. The remaining 20 First City banks were closed in 1992, and the FDIC evaluated each bank separately, determined its value, and decided about whether or not to transfer both insured and uninsured deposits to the bridge banks. The FDIC created a separate bridge bank for each of the 20 banks and depositor treatment varied. The FDIC expected no loss in 16 of the receiverships and all deposits, both insured and uninsured, were transferred to the 16 bridge banks. In four of the receiverships, the FDIC anticipated some loss, and only insured deposits were transferred to the four bridge banks. Of those four, one was a state chartered institution. Because Texas was a "depositor preference" state, the FDIC issued uninsured depositors an advance dividend of 80 percent. The three other failed banks had been national banks and federal law proclaimed that all depositors and other creditors shared ratably in the proceeds of the liquidation. In those banks, the FDIC paid uninsured depositors and unsecured general creditors an 80 percent advance dividend. Later, as it became apparent that the FDIC would not incur any loss in any of the First City transactions, all depositors and general creditors were paid in full.

Creditors

General creditors, sometimes referred to as general trade creditors, are typically the suppliers or service providers of a financial institution. That type of debt is not secured. Examples of general creditors include office supply stores, lawn maintenance services, and outside attorneys.

Before enactment of the National Depositor Preference Amendment, payments to failed bank creditors varied considerably. Each state had its own laws outlining the priority of payments to creditors of state chartered banks. For national banks, however, all creditors (including depositors) shared ratably in the distribution of receivership recoveries. That requirement was an important factor in the decision to pay off insured deposits when Penn Square, a national bank, failed. The FDIC was concerned over the huge amount of potential liabilities from loan participants. Those concerns were based on what is commonly called “the First Empire decision,”¹⁷ in which a court ruled that the FDIC could not prefer one class of similarly situated creditors to another in a national bank receivership. Because of existing law at the time, the FDIC could not have arranged a P&A transaction without insuring the assuming bank against losses on Penn Square’s \$2.1 billion in contingent liabilities, because all creditors, including depositors, had to be treated in the same manner. A payoff of insured deposits was, therefore, the only feasible resolution for Penn Square.

In the resolutions of the First Republic and MCorp banks, the FDIC’s decision to give receivership certificates to the affiliated banks for interbank loans forced the affiliated banks to recognize losses on their balance sheets. The losses rendered the banks insolvent, and those banks also were closed. The lawsuits generated from both resolutions probably were responsible for enactment of FIRREA, which gave the FDIC important leverage in resolutions. FIRREA provides that the FDIC may, in its discretion and to minimize its costs, pay additional amounts to some creditors of a failed depository institution without being obligated to make additional payments to other creditors in the same class.

Shareholders

Open Bank Assistance. Generally speaking, in OBA transactions, the bank’s shareholders should suffer the approximate loss that they would have incurred had the FDIC paid off the bank’s insured deposits and liquidated its assets. In the resolutions of First Penn, Continental, and First City in 1988, shareholders of each institution suffered losses. The losses accrued to the shareholders primarily through the FDIC’s taking of equity positions through stock purchases or the receipt of stock warrants. Legislation passed in 1993 prohibits the use of any deposit insurance funds from benefiting the shareholders of any failing depository institution.

17. *First Empire Bank v. FDIC*, 572 F.2d 1361 (9th Cir. 1978), cert. denied, 439 U.S. 919 (1978).

Deposit Payoffs. Shareholders of the failed Penn Square lost their investments. Under the laws in effect at the time, distributions of the receivership's recoveries were paid ratably to all failed bank creditors and to pay receivership expenses, and only funds left over could be distributed to shareholders. All approved claims were paid at approximately 65 percent of their face amounts, and there were no distributions to Penn Square's shareholders.¹⁸

Purchase and Assumption Transactions. In the cases of First Republic, MCorp, the BNE Corp. banks, and the New Hampshire Plan banks, shareholders lost their entire investments. In the resolution of Southeast, however, shareholders did obtain some value. The transaction resulted in no cost to the FDIC, and other creditors were paid in full. The remainder of the receivership estates, approximately \$120 million in assets, was returned to Southeast. This amount owed to shareholders was the subject of litigation settled in 1998.

Equity

In the majority of the bank failures, the FDIC did not purchase any stock in the newly acquired institution. As the case studies relate, however, it was not uncommon in larger transactions for the FDIC to purchase stock in the new bank or to provide a capital injection in exchange for stock in OBA transactions. There were several reasons for the FDIC to purchase stock in those larger transactions. For institutions of that size to be adequately capitalized, large infusions of funds from the private-sector purchasers would be needed. If the FDIC had limited the bidding to those that had sufficient funds on hand to capitalize the large banks, it would have severely reduced its number of bidders. That, in turn, would have reduced the competitiveness of the bidding process, which may have resulted in situations where the highest bid was not sufficient to complete the transaction. The FDIC was sensitive to the issue of a government agency owning an equity interest in the banks. Most of those transactions, however, were completed so that the FDIC would hold the stock interest for a relatively short time. Federal law also required that the FDIC's interest in the financial institution must be nonvoting, which sufficiently reduced its ability as an investor to control the operations of the new bank. An additional benefit to the FDIC was that the ownership of stock in the newly capitalized (or re-capitalized institution, in the case of OBA) institution allows the FDIC to benefit from any upside if the new bank is successful. As the case studies have shown, most of the stock purchases have been profitable; in only one case did the FDIC lose money on its equity investment.

18. In 1982, the law provided that the liquidation proceeds of any failed national bank would be paid first to each and every creditor of the bank with proven claims and to pay the expenses of the receiver. After that, payments would be made to repay amounts paid in by shareholders by reason of any assessments made upon the failed bank's stock by order of the Comptroller of the Currency. Lastly, payments would be made to pay the balance ratably among the bank's stockholders, in proportion to the number of shares held and owned by each.

OBA Capital Investments

The capital investment by the FDIC took many forms. Each transaction was unique and tailored to particular circumstances. For example, in the First Penn OBA transaction, the FDIC and the other banks that provided First Penn with a loan received warrants for 80 percent stock interest in the stock of the holding company. By placing restrictions of dividends and management action, it provided incentive to First Penn to purchase the warrants and repay its loan from the FDIC as quickly as possible.

In the Continental OBA transaction, the FDIC infused \$1 billion of capital into the bank to allow for its continuing operation. In exchange, the FDIC received two large issues of preferred stock. In addition, the FDIC retained a right to purchase the remaining shareholder interest for a nominal amount because of the large losses that the FDIC had absorbed in the nonperforming loan pool. The FDIC sold its interest over a seven-year period.

In the First City OBA transaction, the FDIC lost the majority of its investment as the bank eventually failed. In that situation, while the FDIC had small gains on the sale of the preferred stock and warrants, it lost a significant investment when it wrote off \$970 million in stock held in the First City "Collecting Bank."

P&A Capital Investments

The capital investments the FDIC made in the acquiring banks also varied widely. In First Republic, the FDIC provided the acquirer with 80 percent of the capital needed to close that large transaction. The acquirer retained the right to repurchase the stock within a five-year period; the price of the stock, however, escalated on an annual basis. The acquirer moved quickly to redeem the stock, repurchasing it in a little more than two years. With the sale of MCorp, although it was completed shortly after First Republic, the FDIC's stock investment in the acquiring institution was different in that it was offset by a corresponding note from the acquirer. The acquirer owned the stock once it paid back the loan.

The BNE transaction also was unique in that the winning bidder provided the FDIC with stock in lieu of a larger premium on the banking franchise. In the Southeast transaction, the FDIC helped capitalize the new institution by providing \$150 million in exchange for stock. That stock contained a clause that allowed its repurchase at par if redeemed within one year. The stock also provided a high dividend rate of 11 percent to induce the acquirer to redeem the stock quickly. That tactic was successful as the acquirer redeemed a portion of the stock within two months and the balance within seven months.

In New Hampshire, there were two transactions involving seven failed banks. Because the FDIC expected the sale of those banks would be difficult, it tried to increase the number of bidders by indicating it would be willing to provide up to two-thirds of the capital needed to operate the new institutions. In the first New Hampshire transac-

tion, acquired by New Dartmouth, the FDIC provided 45 percent of the capital. The stock did not require a dividend, but the redemption price increased annually at a progressive rate. In the second New Hampshire transaction, acquired by First New Hampshire, the stock owned by the FDIC contained a high dividend rate of 10.25 percent. To further induce the acquirer to repurchase the stock, it was provided with redemptive rights for a seven-year period. The stock could be repurchased at par within the first three years, and the price would escalate in each of the final four years. In both of those situations, the acquirer repurchased the FDIC's stock interest within two years.

In the final bank study, CrossLand, the FDIC received warrants as a premium from the investment group that acquired the franchise. Those warrants were sold for a gain of \$18 million in 1996.

The ability to provide acquirers with additional capital has been effective for both the FDIC and the acquirers. It provides the acquirer with the time necessary to establish its new business and to obtain cheaper sources of capital from the private sector. The FDIC has used capital injections on a limited basis, usually for its largest bank failures or OBA transactions. It sets the terms to sufficiently motivate the acquirer to purchase the FDIC's interest.

See table II.12-3 for a summary of the equity investments and their returns.

Reflections

The case studies in Part II were provided to show clear examples of how the FDIC practices its resolution responsibilities and to describe how those practices evolved over time in response to changes in the economy and the various legislative initiatives. Over time, the FDIC gained the ability to solicit out-of-state acquirers, create bridge banks, assess affiliated banks for its resolution costs, and make additional payments to some creditors of a failed institution without making any additional payments to others. The FDIC also developed advance dividend payments, asset management contracting, and loss sharing.

Each of the resolutions is distinctly different from the others, even though some of them occurred only a few months apart. It is clear from the case studies that the resolution of multi-billion-dollar banks is not a simple matter, nor is it a "canned" solution that can be duplicated from one resolution to the next. The case studies show that the FDIC approached each failing bank situation as a unique set of circumstances and developed a resolution strategy that it believed was right for that particular bank.

Table II.12-3

FDIC Failing Bank Equity Investments

(\$ in Thousands)

Bank Name	Nature of Investment	FDIC Stock/ Equity Investment	Disposition Method	FDIC Proceeds from Sales	Gain or Loss On Transaction	FDIC Dividend Income	Total Return on Investment
First Penn	13 million warrants for holding company common stock	\$0	Sold to holding company	\$43,063	\$43,063	\$0	\$43,063
Continental	Preferred stock in holding company; purchase option on former shareholders' stock	1,000,000	Sold to holding company	1,200,109	200,109	202,227	402,336
First City (1988)	Preferred stock in holding company; warrants for holding company common stock; preferred stock in Collecting Bank	1,034,707	Holding company stock and warrants sold to First City; stock in Collecting Bank written off in 1991	108,527	(926,180)	2,059	(924,121)
First Republic	Nonvoting common stock in bridge bank	840,000	Sold to acquiring bank	1,109,682	269,682	4,736	274,418
MCorp	Nonvoting common stock in bridge bank	416,250	Sold to acquiring bank	481,736	65,486	0	65,486
BNE Corp.	Preferred stock in acquiring banks	150,000	Sold to acquirer	160,444	10,444	3,948	14,392
Southeast	Preferred stock in acquiring bank	150,000	Sold to acquirer	150,000	0	6,844	6,844
The New Hampshire Plan	Preferred stock in acquiring banks	81,050	Sold to acquirers	85,766	4,716	10,122	14,838
CrossLand	1 million warrants for bank common stock	23,500	Sold to purchaser of acquiring bank	41,500	18,000	0	18,000

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993).

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